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IN THE

Supreme Court of the United States

OCTOBER TERM, 1942.

No. .....

READING COMPANY, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT, AND BRIEF IN SUPPORT THEREOF.

Comes now the Reading Company, a common carrier by railroad, and prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Third Circuit, entered in the above case on October 23, 1942, affirming the decision of the United States Board of Tax Appeals.

OPINION BELOW.

The memorandum findings of fact and opinion of the Board of Tax Appeals (R. 3a-20a) in favor of the respondent is not officially reported, but may be found at Par. 12,006-D, C. C. H. Board of Tax Appeals Decisions Service and at Par. 41,344, P-H. B. T. A. Memorandum Decision Service. The opinion of the United States Circuit Court of Appeals for the Third Circuit (R. 170) is as yet unreported.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered on October 23, 1942 (R. 178). Petition for a Rehearing was denied on November 19, 1942 (R. 189). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED.

This is a Federal income tax case for the calendar year 1936 and involves the question whether certain advances or loans of $2,805,000 made in 1933, 1934 and 1935 by the petitioner to the Pennsylvania-Reading Seashore Lines (a domestic corporation, the stock of which was owned ⅓ by petitioner and ⅔ by the Pennsylvania Railroad Company), which advances or loans were, in 1936, ascertained by petitioner to be worthless and charged off in that year as uncollectible, are deductible in determining petitioner's 1936 taxable income. The Board of Tax Appeals held in favor of the respondent saying that "The advances made in the years prior to 1936 were worthless before that year, and they should have been so ascertained and charged off"; and that "This is held notwithstanding the contrary opinions of petitioner's several witnesses." The Circuit Court of Appeals for the Third Circuit affirmed the Board.

STATUTES INVOLVED.

The Revenue Act of 1936 (c. 690, 49 Stat. 1648, 1660) provides:

> "SECTION 23. DEDUCTIONS FROM GROSS INCOME.
>
> "In computing net income there shall be allowed as deductions:
>
> • • • • • • • • • •
>
> "(k) Bad debts.—Debts *ascertained* to be worthless and charged off within the taxable year • • •." (Italics supplied.)

STATEMENT.

Prior to 1933, the Pennsylvania Railroad Company and Reading Company each owned a controlling interest in a subsidiary railroad company operating in southern New Jersey.* Pennsylvania's subsidiary was the West Jersey and Seashore Railroad Company, while Reading's subsidiary was the Atlantic City Railroad Company. Both of these subsidiary railroads served substantially the same territory, their lines extending from Camden, New Jersey, to seacoast resorts in southern New Jersey (R. 59a). Atlantic City, the subsidiary of Reading Company, was operated as a separate railroad up to June 24, 1933. The West Jersey, the subsidiary of Pennsylvania, was operated as a separate railroad up to July 1, 1930, and from that date to June 24, 1933, it was operated by Pennsylvania, its parent company, under a 999-year lease (R. 57a).

For several years the revenue of both Atlantic and West Jersey had declined substantially (R. 57a), and the operations of both lines had resulted in deficits. In order to eliminate severe losses resulting from the separate opera-

* Reading Company owned all the preferred stock and over 99 per cent of the common stock of the Atlantic City Railroad Company; Pennsylvania Railroad Company owned approximately 73 per cent of the outstanding stock of the West Jersey and Seashore Railroad Company (R. 57a).

tions of these two railroads serving approximately the same communities, and in order to improve the conditions then existing, an agreement was entered into on November 23, 1932, whereby the two railroads were to be operated as one railroad, namely, as the Atlantic, and duplicate facilities were to be abandoned. To accomplish this, it was agreed that Reading Company would sell to Pennsylvania two-thirds of the stock of the Atlantic City Railroad, and that Pennsylvania would transfer to the Atlantic City Railroad its lease of the West Jersey and Seashore Railroad. It was agreed that in the event Atlantic, so unified, could not meet its operating expenses, taxes, fixed or other charges, Reading and Pennsylvania would lend to Atlantic the necessary sums to cover such deficit, Reading to advance one-third, and Pennsylvania to advance two-thirds (R. 5a-6a).

The Agreement was approved by the Interstate Commerce Commission on June 10, 1933. Reading Company, in accordance therewith, sold to Pennsylvania two-thirds of the capital stock of Atlantic for one dollar ($1.00) and other consideration; Pennsylvania transferred to Atlantic its 999-year lease of West Jersey; and on June 25, 1933, the unified operations of the two railroads became effective. On July 15, 1933, the name of Atlantic was changed to Pennsylvania-Reading Seashore Lines, sometimes referred to as Seashore (R. 59a).

Based on detailed engineering surveys made by Pennsylvania, petitioner and the Public Utilities Commissioner of New Jersey, it was the thought and belief of all concerned that, as a result of the unification of these separate railroads, Seashore could thereafter operate at a profit. However, due to diversion of railroad traffic to highway transportation, and other adverse economic conditions, the operations of Seashore have resulted in deficits every year (R. 59a).

In order to enable Seashore to meet the deficits resulting from its operations, Reading and Pennsylvania, as required

by the Agreement of November 23, 1932, made advances to Seashore of approximately $2,500,000 a year, or total advances to the end of 1935 of $8,415,000, Reading Company advancing one-third ($2,805,000) and Pennsylvania advancing two-thirds ($5,610,000) (R. 59a).

In 1936, the Reading Company ascertained the advances made from June, 1933 to 1935, inclusive, of $2,805,000* to be worthless and charged them off its books as uncollectible (R. 60a). The Board held that: "The advances made in the years prior to 1936 were worthless before that year, and they should have been so ascertained and charged off. This is held notwithstanding the contrary opinions of petitioner's several witnesses." The Circuit Court of Appeals affirmed.

REASONS FOR GRANTING THE WRIT.

I.

Important Question of Federal Law.

Section 23(k) of the Revenue Act of 1936, and similar provisions of other Revenue Acts, provide that, in computing net income, there shall be allowed as deductions debts ascertained to be worthless and charged off within the taxable year. Substantially all, if not all, business enterprises do business on a credit basis and from time to time necessarily incur bad debts. Railroads in particular, under operating agreements approved by the Interstate Commerce Commission, often make substantial loans to other corporations which are parts of their integrated systems, as occurred in the present case.

During 1942 there were approximately 100 decisions by the Board of Tax Appeals (now The Tax Court) and the

* The advances by the petitioner to Seashore from 1933 to 1936, inclusive, amounted to $3,570,000, of which $765,000 was applicable to 1936, which was allowed by the Board, leaving in controversy $2,805,000 advanced in prior years.

courts, involving bad debt deductions. There is, however, a lack of uniformity in the decisions which deal with the question as to the year in which a particular bad debt deduction will be allowed. Some authorities hold that a debt is deductible when it is ascertained by the taxpayer to be worthless, *Rosenthal et al.* v. *Helvering*, 124 F. (2d) 474; others hold that it is deductible when it is *fairly* ascertained by the taxpayer to be worthless, *Rassieur* v. *Commissioner*, 129 F. (2d) 820; and others hold, as in the instant case, that a debt is deductible only if it is ascertained to be worthless in the year in which it in fact became worthless.

The construction of Section 23(k) has not been passed upon by this Court and we believe that it involves an important question of Federal Law.

II.

Conflict of Decisions.

An additional reason for the granting of this writ is that the decision of the court below is in conflict with the decisions of other Circuit Courts of Appeals; particularly, the decision of the Circuit Court of Appeals for the Second Circuit in *Rosenthal et al.* v. *Helvering*, 124 F. (2d) 474, and the decision of the Court of Appeals for the Eighth Circuit in *Rassieur* v. *Commissioner*, 129 F. (2d) 820, both cases holding that bad debts are deductible in the year when ascertained to be worthless.

The decision below is also in conflict with the decision of the Circuit Court of Appeals for the Sixth Circuit in *Capitol-Barg Dry Cleaning Company* v. *Commissioner*, decided December 2, 1942, 131 F. (2d) 712 (Adv. Ops.), holding that The Tax Court may not substitute its own opinion for that of competent witnesses whose integrity was not attacked on matters in which The Tax Court itself had no knowledge or experience upon which it could exercise an independent judgment.

A.

Debts are deductible when ascertained to be worthless.

The Board's opinion (R. 3a-20a), as supplemented by its Memorandum sur Motion for Reconsideration and Amendment of Findings (R. 37a-40a), and the opinion of the court below, hold that although the debts were not ascertained to be worthless prior to 1936, they should have been ascertained to be worthless prior to that year, and, therefore, in law, were ascertained to be worthless prior to that year. This holding is in conflict with the decision by the Circuit Court of Appeals for the Second Circuit in *Rosenthal et al.* v. *Helvering,* 124 F. (2d) 474, 476, which held that

> "debts * * * must be deducted in the year in which the taxpayer 'ascertains' them to be 'worthless'."

The court in *Rosenthal* v. *Helvering, supra,* further stated (p. 476):

> "The statute makes a distinction between the deduction of 'losses' under Sec. 23(e) and (f), and of 'bad debts' under Sec. 23(k). 'Losses' must be deducted in the year in which they are 'sustained' and if the taxpayer fails to learn of them in time, he loses the privilege; debts, on the other hand, must be deducted in the year in which the taxpayer 'ascertains' them to be 'worthless', and nobody understands that this imposes upon him the absolute risk of selecting the year when they actually become so. Commissioner v. MacDonald Engineering Co., 7 Cir., 102 F. (2d) 942, 944; Bartlett v. Commissioner, 4 Cir., 114 F. (2d) 634, 638. However, beginning with Avery v. Commissioner, 5 Cir., 22 F. (2d) 6, 55 A. L. R. 1277, courts have at times charged taxpayers with the duty of selecting that year in which a prudent person with the same information would have concluded that the debt was uncollectible. Indeed, we said as much ourselves in Curtis v. Helvering, Commissioner, 2 Cir., 110 F. (2d) 1014, though the case could probably have been rested upon the taxpayer's failure to carry the burden of proof. In Curry v. Commissioner, 2 Cir., 117 F. (2d) 307, 309, 310, we held,

however, that the 'subjective test' as we called it, was the right one; that is, that the proper year was that in which the taxpayer did 'ascertain' the fact, no matter how much earlier a reasonably prudent person would have done so."

Summarizing the *Rosenthal* case, the court held (p. 476):

(1) "* * * debts * * * must be deducted in the year in which the taxpayer 'ascertains' them to be 'worthless', and nobody understands that this imposes upon him the absolute risk of selecting the year when they actually become so. * * *"

(2) "In *Curry* v. *Commissioner,* 117 F. (2d) 307, 309, 310, we held, however, that the 'subjective test' as we called it, was the right one; that is, that the proper year was that in which the taxpayer did 'ascertain' the fact, no matter how much earlier a reasonably prudent person would have done so."

(3) "*Sabath* v. *Commissioner,* 7 Cir., 100 F. (2d) 569, is the other way. The cases are not in accord, but with deference we can find no ground for importing any 'objective test' into the section. The language does not intimate anything of the sort, * * *."

(4) "We hold therefore that a taxpayer is not charged with the duty of 'ascertaining' the 'worthlessness' of a 'bad debt' at any time before he actually does so."

See, also, *United States* v. *Frost,* 25 Fed. Cas. 1221, 2 A. F. T. R. 2116, 2117:

"The language is, 'ascertained to be worthless'. By whom or how? The law is silent on this important point, and therefore there must be a discretion given to the person making his return, * * *."

To the same effect, see *Commissioner* v. *MacDonald Engineering Co.,* 102 F. (2d) 942.

In the decision by the Court of Appeals for the Second Circuit in *Mayer Tank Mfg. Co., Inc.* v. *Commissioner,* 126 F. (2d) 588, which we submit the court below misconstrued, the taxpayer "ascertained" the debt to be worthless before

the debt was, in fact, worthless. The taxpayer asserted (p. 591) that the Board "should have determined whether this particular taxpayer, in good faith, believed in 1936 that the debt was worthless." The Court said:

> "That argument is founded on a surprising misinterpretation of some of our decisions. We have held that, *if a debt actually becomes worthless in a given year, the taxpayer, notwithstanding that a reasonably prudent person would in that year so have believed, may deduct the debt in a later year, provided that, in good faith and without 'shutting his eyes,' he then first ascertained the fact as to its worthlessness.*" (Italics supplied.)

The case clearly holds that the "reasonably prudent person" theory has nothing to do with the deduction for bad debts. Not only is this true, but in the case at bar we go further and show that since the parties agreed by their pleadings that it was the thought and belief of all concerned that Seashore would operate at a profit, there is not one iota of evidence that the taxpayer acted other than as a reasonably prudent person in waiting a reasonable period, a period of time to test the operations of the Seashore Lines, before making the charge-off.*

The statute provides that in computing net income there shall be allowed as deductions debts ascertained to be worthless and charged off within the taxable year. Both

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* In a number of instances, Congress has used three years as a fair test of operations. Thus, in the Revenue Acts of October 3, 1917 (c. 63, 40 Stat. 300, 303), and 1918 (c. 18, 40 Stat. 1057, 1090), Congress said that the pre-war test period should be three years—1911, 1912 and 1913. With respect to railroads in particular, Congress, in the Transportation Act of 1920 (c. 91, 41 Stat. 456, 460, 464), said that the test period should be three years ending June 30, 1917. To make the thought current, Congress, in the Second Revenue Act of 1940 (c. 757, 54 Stat. 974, 980), laid down the rule that for the purpose of determining excess profits taxes a four year test period—1936 to 1939, inclusive—should be used, and in the recently enacted Revenue Act of 1942 (Public Law 753, 77th Cong., 2d Sess.) this test period is retained without change.

the Board and the court below concluded that by the application of the so-called "objective test" the debts "were ascertained to be worthless before 1936". That is to say, if a prudent person would have concluded that the debts were worthless, then, in law, they were ascertained to be worthless.*

The opinion of the court below in the instant case is also in conflict with the decision of the Circuit Court of Appeals for the Eighth Circuit in *Rassieur* v. *Commissioner*, 129 F. (2d) 820, which decision was published after the briefs were filed in the instant case and after the case was argued. Attention is directed to the following language from that opinion (p. 827):

> "The question as to the notes is when taxpayer reasonably and honestly 'ascertained' the stock, back of the notes, was worthless. This *ascertainment* must be by the taxpayer *Duffin* v. *Lucas*, 6 Cir., 55 F. (2d) 786, 795. Necessarily, there is usually a range of time after actual worthlessness within which a taxpayer may so *ascertain*.
>
> "Taxpayer knew the condition of this company from monthly reports. He knew that from a prosperous, growing business it had been struck down by a panic which affected all business. He knew it owned valuable solvent securities which had been drastically reduced in market value by the panic. He had reason to think, and did think, that the business would go ahead if it could weather the depression. He knew, from in 1931, that liquidation of the business would wipe out the stock value. It was his money in the business. His only prospect of saving that money was to tide the business over to better times. He did this consistently until 1933. Even in January of that year, he assumed, or paid, $51,000 to do this. He did this in the belief that the securities held by the company would come back

* At the hearing, Circuit Judge Jones asked Counsel for Petitioner whether, in law, the debts were "ascertained" to be worthless, if all the surrounding facts showed that they were "ascertainable" to be worthless, although, in fact, they had not been so ascertained.

in the market. This belief was reasonable at all times and was confirmed by subsequent events. See *Clark* v. *Commissioner*, 3 Cir., 85 F. (2d) 622, 625. This belief continued until June 23, 1933, when he first concluded that it was better to give up the idea 'of this company ever going back into business'. There is no dispute in the evidence about this situation and no room for an unfavorable inference of fact therefrom.

"There is no substantial evidence to support denial of the deductions of these notes as bad debts in 1933 and they should be so allowed.

"The order of the Board should be and is reversed."

B.

The decision below, sustaining The Tax Court in substituting its independent judgment for that of petitioner's unimpeached witnesses, is in conflict with the decision of the Circuit Court of Appeals for the Sixth Circuit.

In the instant proceedings, the advances from 1933 to 1935 were ascertained to be worthless in 1936. The Tax Court held that the advances were worthless prior to 1936, and they should have been so ascertained and charged off, the Court stating:

> "This is held notwithstanding the contrary opinions of petitioner's several witnesses."*

In the case of *Capitol-Barg Dry Cleaning Company* v. *Commissioner*, decided December 2, 1942, (C. C. A. 6), 131 F. (2d) 712 (Adv. Ops.), the Circuit Court of Appeals for the Sixth Circuit said (p. 715):

> "The facts, apart from opinion evidence, are uncontroverted and as indicated in the memorandum opinion of the Board, were fully accepted by it. * * * However, the testimony of Wuerdeman and Keys must be viewed in a different light. Their competency was not questioned. Their integrity was not attacked. They were not discredited in any manner known to the law

* The respondent produced no witness whatever.

> and no color, bias, prejudice or self-interest appears in their testimony. Their testimony was unimpeached and should have been accepted by the Board in a matter in which the Board itself had no knowledge or experience upon which it could exercise an independent judgment. *Watjen* v. *Louisville Tob. Warehouse Co.*, 6 Cir., 29 F. 2d 801, 802; *Toledo Grain & Milling Co.* v. *Com'r, supra*, 62 F. 2d at page 173; *Bardach* v. *Com'r*, 6 Cir., 90 F. 2d 323, 326; *Nicholas* v. *Comm'r*, 3 Cir., 44 F. 2d 157, 159. Where the testimony before the Board ought to have been convincing it may not arbitrarily be disregarded."

In the instant case, The Tax Court undertook to exercise an independent judgment without any knowledge or experience upon which it could do so, "notwithstanding the contrary opinions of petitioner's several witnesses". (Par. 12,006-D. C. C. H. Board of Tax Appeals Decisions Service; (R. 17a)).

The following is a brief summary of the opinions of petitioner's several witnesses so disregarded:

Dr. Julius H. Parmelee, Director of the Bureau of Railway Economics since 1920; Ph.D (Economics), Yale University; formerly Instructor in Economics, Yale University (1900-1907); Special Agent and Special Examiner, Interstate Commerce Commission (1907-1909); Special Agent Census Bureau (1910-1911); Statistician, Bureau of Railway Economics (1911-1920), testified (R. 88a):

> "In my opinion the petitioner in 1936 was justified in reaching the conclusion that the advances made by it to the Seashore Lines during the years 1933, 1934, 1935 and 1936 were not collectible and would never be repaid."

Mr. John J. Pelley, President of the Association of American Railways since 1934; formerly Vice-President in charge of operations of the Illinois Central, President of the Central of Georgia Railway (1926-1929), and President of the New York, New Haven & Hartford R. R. (1929-1934); and

certainly one of the most outstanding men in the industry, testified (R. 114a):

> "I think * * * that the management had a perfect right to conclude that the unification was not going to work out as they had planned, and had hoped, and that there would not be a profit, and I think they used good judgment in reaching that conclusion in 1936, and considering these advances as bad debts and proceeding to write them off."

Dr. David Friday, Consulting Economist; Valuation Expert for Michigan Railway Commission (1915); Valuation Expert in various railroad rate cases, testified (R. 125a):

> "I was of the opinion that (in 1936) there was no reasonable expectation * * * that these advances * * * would be collected."

The testimony of these three eminent experts

> "was unimpeached and should have been accepted by the Board in a matter in which the Board itself had no knowledge or experience upon which it could exercise an independent judgment. *Watjen* v. *Louisville Tob. Warehouse Co.*, 6 Cir., 29 F. 2d 801, 802; *Toledo Grain & Milling Co.* v. *Com'r, supra*, 62 F. 2d at page 173; *Bardach* v. *Comm'r*, 6 Cir., 90 F. 2d 323, 326; *Nichols* v. *Comm'r*, 3 Cir., 44 F. 2d 157, 159. Where the testimony before the Board ought to have been convincing it may not arbitrarily be disregarded." *The Capitol-Barg Dry Cleaning Company* v. *Commissioner* (C. C. A. 6), 131 F. (2d) 712, 715 (Adv. Ops.).

The action of the Board in disregarding "the contrary opinions of petitioner's several witnesses", particularly the opinions of Dr. Julius H. Parmelee, Mr. J. H. Pelley and Dr. David Friday, is in direct conflict with the opinion of the Circuit Court of Appeals for the Sixth Circuit in the case of *The Capitol-Barg Dry Cleaning Company* v. *Commissioner*.

It made no difference to the taxpayer in the present case whether the advances were charged off in 1936 or in 1934 or 1935; if they had been charged off in the earlier years a tax benefit would have accrued which would have been just

as beneficial to the taxpayer as if the deduction had been allowed in 1936, except for a difference in rate.* There is, therefore, no occasion to surmise, as did the Court below, that the taxpayer deliberately waited until 1936 for the purpose of taking advantage of an opportunity for tax avoidance.

The denial by the Board of Tax Appeals of the deductions sought and the action of the court below in affirming the Board does make a very material difference in that the taxpayer was not, at any time after the entry of the Board's decision, in a position to claim said amount as a deduction for the year 1934 or 1935. This was by reason of (1) no charge-off having been made in either of those years, as required by the statute, and (2) the bar of the Statute of Limitations with respect to those years.

CONCLUSION.

WHEREFORE, it is respectfully prayed that this petition be granted.

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* Corporate tax rate for the year 1934, 13¾ per cent (Sec. 13 of the Revenue Act of 1934, c. 277, 48 Stat. 680, 686). Corporate tax rate for the year 1935, 15 per cent upon net income in excess of $40,000 (Sec. 13(a) of the Revenue Act of 1934, as amended by Sec. 102 of the Revenue Act of 1935, c. 829, 49 Stat. 1014, 1015). Corporate tax rate for the year 1936, 15 per cent upon net income in excess of $40,000 (Sec. 13 of the Revenue Act of 1936, c. 690, 49 Stat. 1648, 1655).